

Defining Issues[®]

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EITF Approves Three Consensuses

The Emerging Issues Task Force approved three Consensuses at its September meeting, each subject to ratification by the FASB later this month.¹ The new Consensuses apply to how companies account for purchases and sales of inventory with the same party, for modifications of conversion options in debt securities, and for income taxes related to issuing convertible debt with a beneficial conversion feature. The EITF discussed debt that becomes convertible as a result of the issuer's exercise of a call option, but reached no Consensus.

Inventory Exchanges (EITF 04-13)

This Consensus defines when a purchase and a sale of inventory with the same party that operates in the same line of business should be considered a single nonmonetary transaction subject to Opinion 29.² Two or more inventory transactions with the same party should be combined if they are "entered into in contemplation of one another."

According to the Consensus, if one inventory transaction is legally contingent on the performance of another inventory transaction with the same party, the two transactions always meet the "in contemplation of one another" criterion and should therefore always be considered a single exchange transaction subject to Opinion 29. Four other circumstances "may indicate" that the transactions meet the "in contemplation of one another" criterion: off-market terms, simultaneously entering the purchase and sale transactions, relative certainty that reciprocal inventory transactions will occur, and a specific legal right to offset the receivable and payable related to the inventory purchases and sales. Circumstances not described in the Consensus might also indicate that the transactions meet the "in contemplation of one another" criterion. However, separate invoices and the exchange of offsetting cash payments do not necessarily mean that the transactions should be considered separate.

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¹ EITF Issue Nos. 04-13, Accounting for Purchases and Sales of Inventory with the Same Counterparty, 05-7, Accounting for Modifications to Conversion Options Embedded in Debt Securities and Related Issues, 05-8, Income Tax Consequences of Issuing Convertible Debt with a Beneficial Conversion Feature.

² APB Opinion No. 29, Accounting for Nonmonetary Transactions, May 1973. EITF Issue No. 01-2, Interpretations of APB Opinion No. 29, provides guidance on whether the level of monetary consideration (boot) causes the transaction to be considered monetary in its entirety and, therefore, outside the scope of APB 29.

The Consensus also differentiates those non-monetary exchanges of inventory in the same line of business that should be recognized at fair value from those that should be recognized at their carrying amounts. The exchange of finished goods inventory for either raw materials or work-in-process inventory in the same line of business should be recognized at fair value if the transactions have commercial substance and fair values are reasonably determinable.³ In contrast, the transfer of raw materials or work-in-process inventory for the receipt of raw materials, work-in-process, or finished-goods inventory in the same line of business, or the exchange of finished goods for finished goods in the same line of business, would be accounted for at the recorded amount of the assets transferred.

When applying the guidance in this Consensus, raw materials, work-in-process, and finished goods should be classified the same way the company classifies them for external financial reporting purposes. If nonmonetary exchanges of inventory are recognized at fair value based on the application of this Consensus, the amount of revenue and costs or gains and losses that are recognized should be disclosed.

If ratified by the FASB, the Consensus should be applied to new arrangements entered into in reporting periods beginning after March 15, 2006. No adjustment should be made to the carrying amount of any inventory that was acquired under these types of arrangements prior to initially applying the Consensus

and still remains in an entity's statement of financial position. Early application is permitted in periods for which financial statements have not been issued.

The final EITF 04-13 Abstract will include examples illustrating how to apply the new requirements.

Modifications to Conversion Options (EITF 05-7)

The EITF's Consensus on Issue 05-7 requires that a change in the fair value of a conversion option brought about by modifying the debt agreement be included in analyzing in accordance with EITF 96-19 whether a debt instrument is considered extinguished.⁴

Under EITF 96-19's requirements, an issuer who modifies a debt instrument must compare the present value of the original debt instrument's cash flows to the present value of the cash flows of the modified debt. If the present value of those cash flows varies by more than 10 percent, the modification is considered significant and extinguishment accounting is applied to the original debt. If the change in the present value of the cash flows is less than 10 percent, the debt is considered to be modified and is subject to EITF 96-19's modification accounting. EITF 05-7's Consensus requires that in applying the 10 percent test the change in the fair value of the conversion option be treated in the same manner as a current period cash flow.

The Consensus also requires that, if a modification does not result in an extinguishment,

the change in fair value of the conversion option be accounted for as an adjustment to interest expense over the remaining term of the debt. The issuer should not recognize a beneficial conversion feature or reassess an existing beneficial conversion feature upon modification of the conversion option of a debt instrument that does not result in an extinguishment.

If ratified by the FASB, the Consensus will be generally effective for periods beginning after December 15, 2005. However, the SEC Observer noted that the EITF's conclusion that changes in the fair value of a conversion option should be considered a current period cash flow when evaluating whether an extinguishment has occurred is consistent with the position taken in a speech by a member of the SEC staff at the December 2004 AICPA Conference on Current SEC and PCAOB Developments. The SEC staff therefore expects registrants to apply that aspect of the Consensus for modifications that occurred after the date of that speech.

Tax Effects of Beneficial Conversion Features (EITF 05-8)

Under EITF 05-8, the issuance of convertible debt with a beneficial conversion feature results in a temporary difference for purposes of applying Statement 109.⁵ The deferred taxes recognized for the temporary difference should be recorded as an adjustment to paid-in capital.

EITF 98-5 and EITF 00-27 require that the nondetachable conversion feature of a con-

³ FASB Statement No. 153, *Exchanges of Nonmonetary Assets*, December 2004, par. 2, available at www.fasb.org.

⁴ EITF Issue No. 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments*.

⁵ FASB Statement No. 109, *Accounting for Income Taxes*, February 1992, available at www.fasb.org.

vertible debt security be accounted for separately if it is a beneficial conversion feature.⁶ A beneficial conversion feature is recognized and measured by allocating to additional paid-in capital a portion of the proceeds equal to the conversion feature's intrinsic value. A discount on the convertible debt is recognized for the amount that is allocated to additional paid-in capital. The debt discount is accreted from the date of issuance to the stated redemption date of the convertible instrument or through the earliest conversion date if the instrument does not have a stated redemption date. The U.S. Federal Income Tax Code includes the entire amount of proceeds received at issuance as the tax basis of the convertible debt security.

For example, Company A receives proceeds of \$100 for issuing convertible debt with a stated principal amount of \$100 and a beneficial conversion feature of \$20. For financial reporting purposes, the company recognizes cash proceeds of \$100, convertible debt of \$100 with a debt discount of \$20 (net book basis of \$80), and a beneficial conversion feature of \$20, which is recorded through additional paid-in capital. The tax basis in the convertible debt instrument is \$100. According to the EITF 05-8 Consensus, the \$20 difference is a temporary difference, and deferred taxes should be recognized on that difference with an offsetting adjustment to paid-in capital.

The EITF 05-8 Consensus should be applied retrospectively to all instruments with a beneficial conversion feature accounted for

under EITF 98-5 and EITF 00-27 for periods beginning after December 15, 2005. Early application is permitted in periods for which financial statements have not yet been issued.

Conversion Triggered by Call Option (EITF 05-1)

The EITF discussed accounting for the conversion of a debt instrument triggered by the issuer's exercise of a call option and will continue to consider it at the next meeting.⁷ Debt instruments may become convertible into common shares at the holder's option when a contingent event occurs, such as when the issuer's common stock price has exceeded a predetermined threshold for a specified time period (a market price trigger). Some convertible debt may have additional contingencies that would allow the holder to convert the debt (e.g., if the issuer calls the debt, the issuer's debt is downgraded, there is a change in control, or a bond trading price "parity" condition occurs). At its March meeting the EITF reached a tentative conclusion on how to account for the conversion of an instrument that becomes convertible upon the issuer's exercise of a call option that otherwise is not convertible or not currently convertible based on a contingency other than the passage of time. The issue was discussed further in the June and September meetings, and some Task Force members have introduced alternatives that would have different accounting results.

Other Matters

The Task Force modified the Consensus on EITF 05-6 reached at the June 2005 EITF

meeting and heard the Chairman's report on staff responses to inquiries related to the effects of Hurricane Katrina.⁸

Issue 05-6. The Task Force agreed in its June meeting that leasehold improvements acquired in a business combination should be amortized over the lesser of the useful life of the assets or a term that includes renewals determined to be reasonably assured at the date of the business combination (i.e., the "hypothetical" lease term). Significant leasehold improvements acquired well after the lease commencement date would be amortized over the lesser of the useful life of the leasehold improvements or the hypothetical lease term.

The EITF modified the Consensus on EITF 05-6 reached at the June 2005 EITF meeting to clarify that it does not apply to other leasehold improvements. The Consensus should therefore not be used as the basis for reevaluating the amortization period for leasehold improvements that were placed into service at or near the beginning of the lease term.

Hurricane Katrina. A financial-institution regulator asked the FASB staff whether the sale or transfer of a held-to-maturity security as a direct result of the effects of Hurricane Katrina would call into question the investor's intent to hold other debt securities classified as held-to-maturity. Paragraph 8 of Statement 115 says that "events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably

⁶ EITF Issue Nos. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, and 00-27, Application of Issue 98-5 to Certain Convertible Instruments.

⁷ EITF Issue No. 05-1, Accounting for the Conversion of an Instrument That Becomes Convertible upon the Issuer's Exercise of a Call Option.

⁸ EITF Issue No. 05-6, Determining the Amortization Period for Leasehold Improvements.



anticipated may cause the enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity.”⁹ The staff told the regulator that, in limited circumstances for certain entities, the sale or transfer of a held-to-maturity security as a direct result of the effects of Hurricane Katrina might be a change in circumstances of the type described in paragraph 8 of Statement 115, which would not call into question the entity’s intent to hold other debt securities to maturity in the future. Based on the staff’s statement, we believe that each case will need to be considered in light of its facts and circumstances.

There are no plans for either the FASB or the EITF to issue formal guidance on the accounting implications of Hurricane Katrina’s effects, but the AICPA issued Technical Practice Aid 5400.05. It addresses liability recognition for costs related to the hurricane damage, impairment evaluations, accounting for insurance recoveries, income statement presentation, and disclosures.¹⁰



The FASB will consider ratifying the Consensuses September 28, 2005. The official minutes to the September EITF meeting are expected to be posted to the FASB Web site early in October. The EITF’s next meeting is currently scheduled for November 9-10, 2005.

The descriptive and summary statements above are not intended to be a substitute for the text of the EITF’s Consensuses, tentative conclusions, or official minutes; FASB Statements; APB Opinions; or any of the other potential or actual requirements. Nor are any of the cited documents necessarily applicable to any entity’s specific circumstances. In determining the appropriate accounting treatment for a transaction, one should refer to the texts of the applicable documents that set out requirements, including the formal EITF meeting minutes that will be made available on the FASB Web site, and consult their accounting and legal advisors.

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⁹ FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, May 1993, available at www.fasb.org.

¹⁰ AICPA Technical Practice Aid 5400.05, *Accounting and Disclosures Guidance for Losses from Natural Disasters—Nongovernmental Entities*.